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ABSTRACT

This instructor guide for a unit on types of ownership in the PACE (Program for Acquiring Competence in Entrepreneurship) curriculum includes the full text of the student module and lesson plans, instructional suggestions, and other teacher resources. The competencies that are incorporated into this module are at Level 3 of learning--starting and managing one's own business. Included in the instructor's guide are the following: unit objectives, guidelines for using PACE, lists of teaching suggestions for each unit objective/subobjective, model assessment responses, and overview of the three levels of the PACE program. The following materials are contained in the student's guide: activities to be completed in preparation for the unit, unit objectives, student reading materials, individual and group learning activities, case study, discussion questions, assessment questions, and references. These four objectives are addressed: analyze the appropriate choice of ownership for one's business; identify the steps necessary to file ownership for one's business; define policies and procedures for a successful multiple-owner operation; and discuss reasons for obtaining outside assistance in ownership choices. (YLB)

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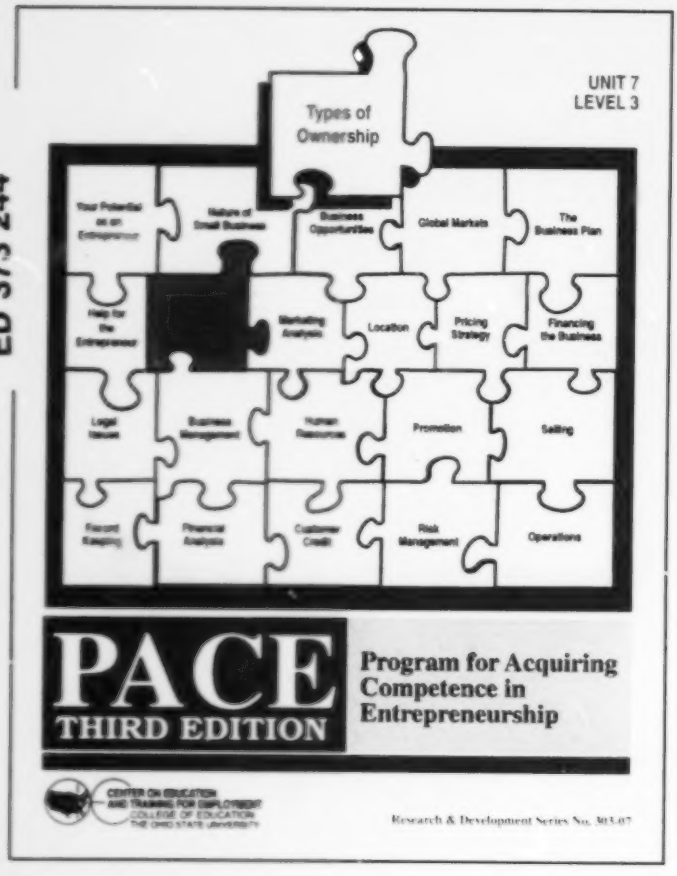

Objectives:

- Analyze the appropriate choice of ownership for your business.
- Identify the steps necessary to file ownership for your business.
- Define policies and procedures for a successful multiple-owner operation.
- Discuss reasons for obtaining outside assistance in ownership choices.

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INSTRUCTOR GUIDE

Unit 7

Types of Ownership

Level 3

HOW TO USE PACE

- Use the objectives as a pretest. If a student is able to meet the objectives, ask him or her to read and respond to the assessment questions in the back of the module.
- Duplicate the glossary from the *Resource Guide* to use as a handout.
- Use the teaching outlines provided in the *Instructor Guide* for assistance in focusing your teaching delivery. The left side of each outline page lists objectives with the corresponding headings (margin questions) from the unit. Space is provided for you to add your own suggestions. Try to increase student involvement in as many ways as possible to foster an interactive learning process.
- When your students are ready to do the *Activities*, assist them in selecting those that you feel would be the most beneficial to their growth in entrepreneurship.
- Assess your students on the unit content when they indicate they are ready. You may choose written or verbal assessments according to the situation. Model responses are provided for each module of each unit. While these are suggested responses, others may be equally valid.

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Objectives	Teaching Suggestions
1. ANALYZE THE APPROPRIATE CHOICE OF OWNERSHIP FOR YOUR BUSINESS	
What is the best choice of ownership for your business?	Introduce students to basic factors which should be considered when choosing the type of ownership.
What is a sole proprietorship?	Have students define sole proprietorships. Add other characteristics of sole proprietorships to provide students with a thorough understanding of the concept.
What are the advantages of a sole proprietorship?	Divide the class into two teams. One team is to analyze advantages, and the other is to analyze disadvantages of sole proprietorships.
What are the disadvantages of a sole proprietorship?	Refer to above suggestion.
How are sole proprietorships taxed?	Use a simplified numerical example—excluding deductions—to prove the simplicity of taxation in sole proprietorships (e.g., consider that the owner's personal income before tax is $50,000 per year. Add to this number the income the business generated, say $70,000. Use a 40 percent tax bracket to compute the after-tax income: (1-0.40) x ($50,000 + $70,000) = $72,000.
What is a partnership?	The instructor should help students correctly define partnerships.
What are different types of partnerships?	Help students correctly differentiate general and limited partnerships.
What are the advantages of a partnership?	Invite a local entrepreneur to relate his/her own experience in a partnership. The speaker should outline both advantages and disadvantages of partnerships.
What are the disadvantages of a partnership?	Refer to above suggestion.
How are the partnerships taxed?	Use a simplified numerical example to show how partnerships are taxed. Highlight taxation advantages for the partners.
What is a corporation?	Help students to define and understand the concept of corporation. Have them give examples of corporations in various industries.
What are the advantages of a corporation?	Use the Exxon Valdez oil spill to illustrate advantages and disadvantages for corporations.
What are the disadvantages of a corporation?	Refer to above example.
What about the corporation and taxes?	The instructor might want to use a chart to highlight some important aspects of different taxation in S-corporations versus C-corporations.
2. IDENTIFY THE STEPS NECESSARY TO FILE OWNERSHIP FOR YOUR BUSINESS	
How is a sole proprietorship formed?	Have students work in teams to develop summary plans for forming sole proprietorships. Offer students a few hints to help them better understand their tasks.

Objectives	Teaching Suggestions
How is a partnership formed?	Refer to above suggestion.
3. DEFINE POLICIES AND PROCEDURES FOR A SUCCESSFUL MULTIPLEOWNER OPERATION	
What issues should be covered in a partnership agreement?	The instructor should lead an open discussion on what issues should be covered in a partnership agreement. These issues should be listed using a chalkboard or overhead to help students summarize important aspects of partnership agreements.
How is a corporation formed?	Distribute copies of the Articles of Incorporation as presented in the text. Help students fill out the sample on their own to acquaint themselves with various issues which characterize the articles of incorporation.
4. DISCUSS REASONS FOR OBTAINING OUTSIDE ASSISTANCE IN OWNERSHIP CHOICES	
How can you analyze your business situation to determine the type of ownership?	Lead students in a discussion on factors that should be considered when making decisions related to choice of ownership. This should be a detailed discussion driven by the factors mentioned at the beginning of the class.
How can outside assistance help you make better choice of ownership?	It is important to convey the message that legal advisors are critical in helping entrepreneurs choose the type of ownership most appropriate for the business.

MODEL ASSESSMENT RESPONSES

1. A sole proprietorship is the easiest type of business to form and operate. A sole proprietorship is owned by only one person. The owner need not file registration forms in order to start the business, except for some states in which the business' name differs from the owner's name. In some cases, obtaining a license may be required.

   A partnership is formed with little formality. In fact, no registration forms need be filed to start a partnership. Although not required by law, partnership agreements are recommended. Agreements help formally establish the partners' rights and obligations, and conditions to terminate the partnership if one of the partners, gets ill, or dies, or otherwise is incapable of living up to the agreement.

   A corporation is formed by filing registration forms with the state, local, and national government agencies. Registration procedures vary from state to state. However, there is some common information required for a charter: (1) specific name of the corporation, (2) purpose of the corporation, (3) names and addresses of the directors and incorporators, (4) location of the company's main office, (5) duration of the corporation, (6) amounts and kinds of capital stock authorized at the outset of the operation, and (7) a full description of the voting rights of the stockholders.

2. There are several factors that might influence an entrepreneur's decision to choose a particular type of ownership: (1) start-up costs, (2) the amount of control and risk he/she desires, (3) need for assistance in particular areas, (4) need for continuity, (5) personal flexibility, and (6) to develop your own business idea.

   Start-up cost have to be considered in connection with your personal financial situation. If you are rich enough not to care about additional expenses required to start a business, you might choose to form a corporation which offers the advantage of limited liability. If you do not have a great deal of savings, you might consider a sole proprietorship or a partnership to benefit from the relatively low start-up costs.

The amount of control and risk you desire will influence your decision to choose a particular form of ownership. If you are not interested in actively managing the business or you are not a high-risk-taker, you might choose a limited partnership or a corporation. High-risk takers and people who are interested in directly controlling their business will probably choose sole proprietorships.

Other personal characteristics, such as the need for continuity and flexibility will also influence the choice of ownership. If you feel a need to ensure continuity for your business, you might want to start a corporation. If you are a flexible person and self-disciplined, a corporation might again be the right choice. On the other hand, if you do not want to have co-owners and like to do things your own way, a sole proprietorship may satisfy your goals.

Your specific business idea is another factor which may influence your decision to choose a type of ownership. If your business plan requires a larger amount of start-up capital (such as a high-technology businesses), you will probably want to form a corporation or partnership which by nature creates opportunities to raise capital.

3. A partnership agreement lists, in writing, all the details about the partners' rights and obligations in forming a partnership, as well as provisions to handle problems that might occur in the future. A written agreement will make relationships among partners stronger and smoother. In addition, it helps partners to anticipate future problems.

   Partnership agreements include provisions on: (1) duration of the partnership, (2) the authority and duties of the partners, (3) the amount invested by each partner, (4) salaries of the partners, (5) profit sharing, (6) conditions on adding partners and selling partnership interests, and (7) conditions on terminating the partnership.

4. Seeking outside assistance will help entrepreneurs make the right decision when choosing a type of ownership. This decision involves complex technical problems (such as business law and taxes) which can be handled properly only by attorneys, accountants, or the Small Business Administration professionals. These professionals keep current on changes which constantly affect small business' legal issues. Experts can help you better understand your options and make a better decision about ownership.

   In addition, outside professionals have a more objective perspective of your situation. The assistance they provide is unbiased and will identify potential problems beyond your personal expertise.

PACE
THIRD EDITION

Program for Acquiring Competence in Entrepreneurship

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Level 2 — Planning for a business in your future.
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For information on PACE or to order, contact the Publications Department at the
Center on Education and Training for Employment, 1900 Kenny Road, Columbus, Ohio 43210-1090
(614) 292-4353, (800) 848-4815.

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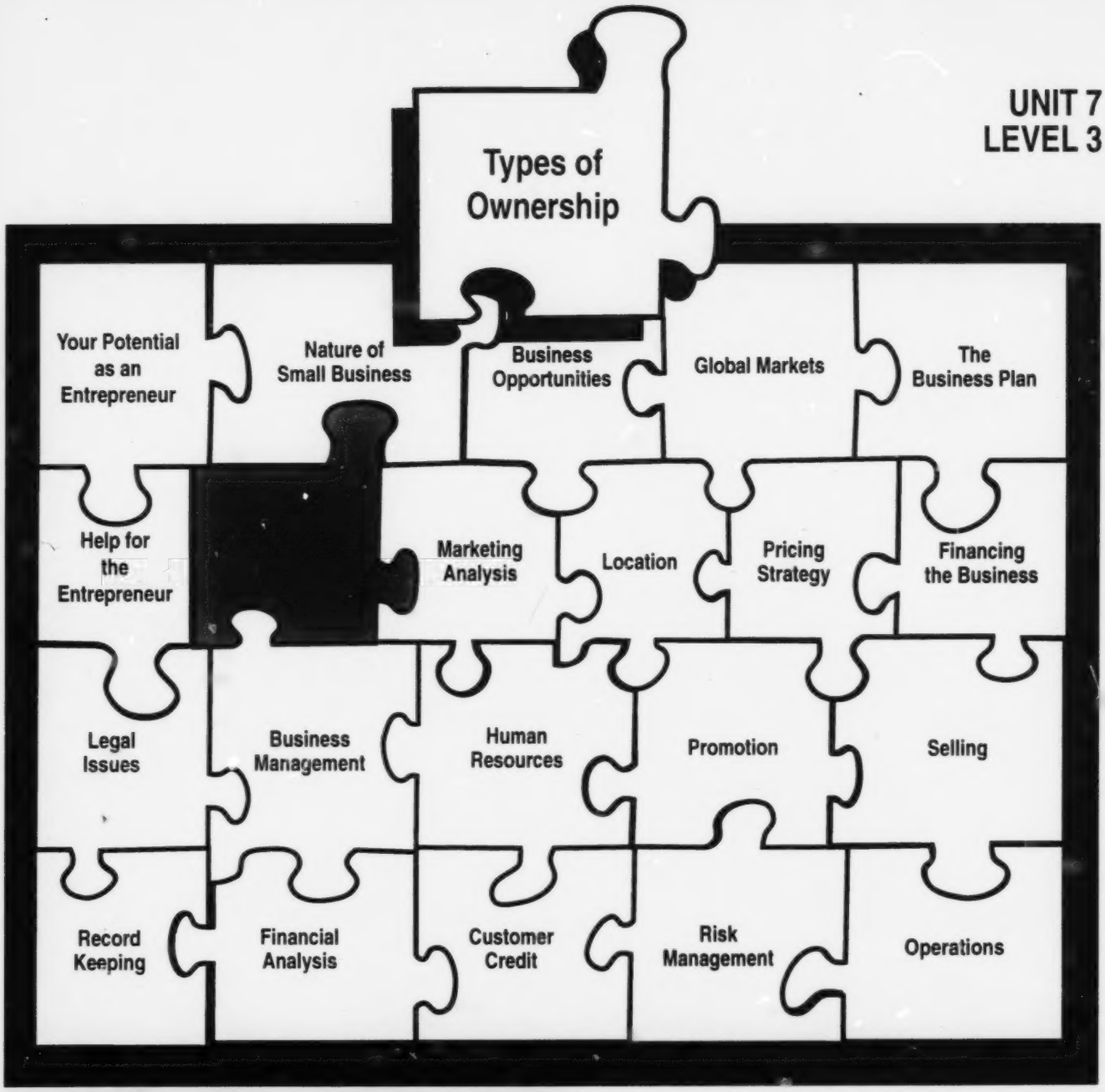
UNIT 7
LEVEL 3



PACE
THIRD EDITION

Program for Acquiring Competence in Entrepreneurship

CENTER ON EDUCATION AND TRAINING FOR EMPLOYMENT
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THE OHIO STATE UNIVERSITY

Research & Development Series No. 303-07

TYPES OF OWNERSHIP

BEFORE YOU BEGIN . . .

1. Consult the *Resource Guide* for instructions if this is your first PACE unit.

2. Read What are the Objectives for this Unit. If you think you can meet these objectives now, consult your instructor.

3. These objectives were met in Level 1 and Level 2:

   Level 1

   - Describe sole proprietorships, partnerships, and corporations.
   - Identify the advantages and disadvantages of proprietorships, partnerships, and corporations.

   Level 2

   - Explain the basic principles of a sole proprietorship, a partnership, and a corporation.
   - Identify the factors that influence the choice of ownership type.
   - Investigate sources of assistance in choosing ownership type.

4. Look for these business terms as you read this unit. If you need help with the meanings, ask your instructor for a copy of the PACE Glossary contained in the *Resource Guide*.

   Articles of Incorporation
   Bylaws
   Corporate charter
   Corporate tax rate
   Personal income tax rate
   Shareholder

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TYPES OF OWNERSHIP

WHAT ARE THE OBJECTIVES FOR THIS UNIT?

Upon completion of this unit you will be able to—

- analyze the appropriate choice of ownership for your business,
- identify the steps necessary to file ownership for your business,
- define policies and procedures for a successful multiple-owner operation, and
- discuss reasons for obtaining outside assistance in ownership choices.

WHAT IS THIS UNIT ABOUT?

In today's complex business environment, starting a new business is more challenging than it has ever been. Deciding on the form of ownership for your business is important and should be done early in the process of starting the business. As your situation changes, you should review your choice to determine if a different form of ownership would suit your new situation better.

To determine the best form of ownership for your business, you will need to compare your specific circumstances and needs with the advantages and disadvantages of each form of ownership. Your particular circumstances are what counts when making this decision. What may be a pressing concern for one entrepreneur may not be a concern for another entrepreneur.

The purpose of this unit is to help you analyze the appropriate choice of ownership for your business. This unit offers information on the types of ownership, how to set up each type, and policies and procedures necessary for the successful operation of multiple-owned businesses. Additional reasons for seeking professional assistance when analyzing the form of ownership to choose are also discussed.

WHAT IS THE BEST CHOICE OF OWNERSHIP FOR YOUR BUSINESS?

As an entrepreneur, you must analyze the appropriate choice of ownership for your business. You should weigh such factors, as start-up costs, the amount of control you

desire, the amount of personal risk you are willing to assume, your need for assistance in particular areas, and the amount of regulation with which you wish to deal.

WHAT IS A SOLE PROPRIETORSHIP?

A sole proprietorship is a business that is owned by one person and is not incorporated. Any size or type of business could be run as a sole proprietorship. Sole proprietorships can be anything from a small TV repair shop to a large manufacturer of computers. The key factor to remember is that sole proprietorships are businesses that have only one owner and are not incorporated.

Sole proprietorships are the most common form of business ownership in the United States. The reason for this is that most new small business owners choose to be sole proprietors. They do so because sole proprietorships are the easiest type of ownership to form and operate. Generally, the only legal requirements involved in forming a sole proprietorship are that the necessary business licenses be obtained and the business name, if it is a name other than that of the owner, be registered before the business is operated.

Once started, sole proprietorships face less government regulations and require less paper work than partnerships and corporations. The owner makes all of the decisions and reaps all of the rewards. Taxes are simplified because the owner treats business profits and losses as part of his/her personal finances. This is less complicated than the tax report rules for either a partnership or corporation.

WHAT ARE THE ADVANTAGES OF A SOLE PROPRIETORSHIP?

The chief advantage of a sole proprietorship is its simplicity. That is, it is easier and less expensive to start and operate than either a partnership or corporation. There are less government regulations, less paper work, and less complicated tax rules. This enables the sole proprietor to focus his or her time and financial resources on developing the business instead of dealing with regulations and paper work.

A second feature of a sole proprietorship that is often attractive to entrepreneurs is the freedom and control enjoyed by an individual owner. Sole proprietors call all the shots for their business and answer to no one about their choices. They make the business work and get to enjoy all the fruits of their labor. Of course, they also bear the responsibility for any losses as well.

WHAT ARE THE DISADVANTAGES OF A SOLE PROPRIETORSHIP?

The clearest disadvantage to being a sole proprietorship is the assumption of *unlimited personal liability* for business debts. This means that sole proprietors must pay their business debts even if their businesses do not generate enough money to pay the bills. Business creditors can force sole proprietors to pay business debts with funds from personal savings and investments or from the sale of personal possessions such as a home,

cars, and jewelry. In the worst case scenario, the failure of a sole proprietorship can result in personal bankruptcy.

Another disadvantage is that an individual usually finds it more difficult to raise capital than do groups of individuals. Sole proprietors have less funds and less borrowing power than they would if they teamed up with others to start a business. This is why many sole proprietors find it necessary to take on additional owners to make their business grow. See Figure 1 for a summary of the advantages and disadvantages of a sole proprietorship.

sole proprietor's personal income for tax purposes. The personal income tax rate on profits is often lower than the corporate tax rate. Income earned by a corporation may also be subject to double taxation.

Corporate income is first taxed at the corporate rate when the corporation earns it. The income is then taxed a second time when it is distributed to the owners as dividends. In addition, a sole proprietor can offset some losses against other sources of personal income whereas losses for a corporation may not be offset against personal income of the owners.

ADVANTAGES	DISADVANTAGES
• Easy to form and terminate • Low start-up costs • Owner has authority to make all decisions • Relatively little regulation and paper work • All profits go to owner • Possible tax benefits	• Unlimited liability for owner • Harder to raise capital than for other types of business ownership • Limited amount of management expertise • Lack of continuity

Figure 1. Summary of the Advantages and Disadvantages of a Sole Proprietorship

HOW ARE SOLE PROPRIETORSHIPS TAXED?

An important advantage of a sole proprietorship is in the area of taxes. The proprietor's operations are treated as part of the owner's financial activities. Although separate records are kept of business income, deductions, inventories, and capital acquisitions, profit or loss is combined with the

These differences in the way sole proprietorships and corporations are taxed can result in a tax savings for the sole proprietor. However, using careful tax planning and the election of the appropriate tax status may make it possible to lessen the disadvantage for the corporate form. (The issue of double taxation and the benefits of S corporation status will be covered later in this unit when corporate taxes are discussed).

HOW IS A SOLE PROPRIETORSHIP FORMED?

A sole proprietorship is the easiest type of business ownership to form. In fact, if a single-owned business is started without the owner doing anything to form a specific type of ownership, that business will be a sole proprietorship. Of course it is wiser to choose the sole proprietor option after a thorough analysis of the options instead of by accident.

Although not required to form a sole proprietorship, there are several things that are highly recommended. Depending on the type of business and its location, a license may be needed to operate legally. Additionally, the business may need to be registered if its name is different from the owner's name. Finally, all businesses, regardless of the type of ownership, should develop a business plan.

WHAT IS A PARTNERSHIP?

Partnerships are very similar to sole proprietorships, however they involve more than one owner. Any business that has more than one owner and is not incorporated is a partnership.

Often partnerships are created when a sole proprietor decides he or she needs more capital or management expertise to run the business properly. A partnership is formed to bring the necessary money or skills to the business so that it can grow. The partners then split the profits from the growing business.

There is no legal requirement that forces partners to have a written partnership agreement. However, it is strongly recommended that partners discuss the details of their business relationship and put them in writing. Most partners find that clarifying their agreements up front and putting the details in writing helps them avoid problems that commonly occur as the business grows.

WHAT ARE THE DIFFERENT TYPES OF PARTNERSHIPS?

There are two types of partnerships—*general partnerships* and *limited partnerships*. The difference between the two types centers around whether or not all the partners participate in the management of the business. In a general partnership there is only one class of partners—*general partners*. All the general partners can actively participate in managing the business. Because all partners in a general partnership have a say in how it is managed, they are held personally liable for all debts of the business. The personal liability of general partners is the same as that of sole proprietors.

General partnerships are used in situations where all the parties want to have a role in actively managing the business. Many times the best way to run the business successfully is if each of the partners contribute his or her management talent to the effort. When all the partners contribute significant amounts of capital to the partnership, they all usually want to be involved in managing the business.

Limited partnerships have two classes of partners—*general partners and limited part-*

ners. The general partners manage the business and have unlimited personal liability for all debts of the business. There must be at least one general partner in every limited partnership. On the other hand, limited partners only invest money in the business. They do not participate in the management of the business. Because they do not have a say in managing the business, they are not personally liable for the debts of the business. The limited partner's financial liability is limited to the amount they have invested in the business. Their personal assets can not be taken to pay the debts of the business.

Limited partnerships are used when the entrepreneur needs more capital but does not want to share management responsibilities. The entrepreneur becomes a general partner and seeks investors to become limited partners. The limited partners put up the needed capital and earn a return on their investment. They do not participate in management decisions and they are not personally liable for the debts of the business.

WHAT ARE THE ADVANTAGES OF A PARTNERSHIP?

The principal advantage of a partnership over a sole proprietorship is that a group of owners has a larger pool of expertise and money than does a single owner. Bringing in partners enables the business owner to secure the money and skills needed to support the growth of the business.

A partnership has two advantages over a corporation. First, partnerships are generally easier to form than a corporation. There is much less paper work required and government regulation to deal with in starting a partnership. It is usually less costly to start a partnership than a corporation due to the ease of formation.

The second advantage involves the way partnerships and corporations are taxed. Partnership's profits and losses flow through to the partners personal tax return. Corporations profits and losses are taxed on the corporations tax return. Corporate profits are taxed again on the personal tax return of the owners when the profits are distributed. Corporate losses do not pass through to the owners. In times of business losses, in a partnership, partners can use the losses to get a tax advantage by offsetting the loss against other sources of income. This results in a lower taxable income and a tax savings to the partners. Since corporate losses do not flow through to the owners, except when S corporation status is elected, this tax advantage is not available to all corporations.

WHAT ARE THE DISADVANTAGES OF A PARTNERSHIP?

The biggest disadvantage of a partnership is unlimited liability for the general partners. The general partners in a limited partnership and all the partners in a general partnership are held personally liable for all the debts of the business. This includes debts that other partners incur on behalf of the partnership even if those debts are unknown to the partners who are being asked to pay it. The large risk associated with being a general partner has caused many entrepreneurs to avoid forming a partnership.

Another major disadvantage of a partnership is the difficulty involved in controlling what happens when partners either want to leave the partnership or are forced to leave due to illness, disability or death. Generally, when a general partner leaves the partnership it comes to an end and the remaining partners must form a new partnership. If the partners have a written partnership agreement, they can avoid this problem if they included a provision that covers the buyout of a partner's interest who leaves the business. Corporate ownership interests and stocks are made to be transferred while partnership interests are not. Dealing with owners leaving the business is more complicated in a partnership than in a corporation. See Figure 2 for a summary of the advantages and disadvantages of a partnership.

period that ends within the period being reported (by December 31 or June 30). This is done whether profits are actually distributed then or not.

A major potential benefit of having tax consequences flow directly through to the partners' personal income is that losses may be available to offset other income of the owner. This can be very important in the first few years of business when losses are very likely. Tax savings from deducting partnership losses from other personal income can be a useful source of cash in the start up phase or during any down turn in the business.

Whether being taxed as a partnership is more advantageous than being taxed as a

ADVANTAGES	DISADVANTAGES
• Ease of formation • Greater availability of management expertise and capital • All profits go to owners • Possible tax benefits • Less regulated than a corporation	• Unlimited liability • Difficult to terminate • Unstable business life • Difficult to transfer partnership interest • Acts of one partner binds all partners (Agency law)

Figure 2. Summary of the Advantages and Disadvantages of a Partnership

HOW ARE THE PARTNERSHIPS TAXED?

Taxes on a partnership are reported and paid like those on a sole proprietorship. On each partner's personal income tax return, income from the business is reported. Tax is paid on the business along with tax on any other income. The partner reports his or her share of the profit earned during the tax

sole proprietorship depends entirely on your particular situation. The following questions will help you assess your situation:

- Are you anticipating a profit or a loss?
- How big a profit do you anticipate producing?
- Do you have income from sources outside the business?

- Do you anticipate capital gains or losses?
- Do you plan on making large charitable contributions?
- Are there alternative minimum tax issues?
- Do you use cash or accrual accounting methods?

Tax experts such as tax attorneys and accountants should be consulted when developing a tax plan. They not only will help you comply with the tax laws, they will help you understand the tax ramifications of the various forms of ownership so you can choose the type of ownership that will result in the lowest taxes. It is also a good idea to seek tax advice from a professional from time to time. Your tax plan should be revised as the business grows and your tax position changes, as well as when the tax laws change.

HOW IS A PARTNERSHIP FORMED?

A partnership can be formed with very little formality. In fact, if two entrepreneurs get together and start a business, they have formed a partnership. No formal partnership agreement is required. However, it is almost always better to take the time and spend the money to develop a written partnership agreement. The costs are not that great and the partners usually find that discussing their agreement up front and putting it in writing helps them avoid misunderstandings in the future. A strong, well-thought-out partnership agreement can spell the difference between an effective partnership whose partners work toward a common goal and an ineffective partnership whose partners spend more time disagreeing about details than working.

WHAT ISSUES SHOULD BE COVERED IN A PARTNERSHIP AGREEMENT?

A good partnership agreement does two things. First, it lists in writing all the details of agreements the partners reached in the process of forming their partnership. Issues such as how much each partner will invest and how profits and losses will be split are issues on which the partners usually reach an agreement. Detailing those agreements can help avoid straining the partners' working relationship in the future when it comes time to deal with these issues.

The second area a good partnership agreement should cover is provisions for handling problems that may occur in the future. An example of such an issue is how to dissolve the partnership if one of the partners wants to leave the partnership and sell his or her interest.

The provisions that could be included in a partnership agreement depend on the agreement that partners make and the circumstances. However, following is a list of key areas covered by most typical partnership agreements.

The duration of the partnership. The partners should discuss how long the partnership will last. Will it be for a limited time period such as 1 or 2 years? Will it be until a certain business event occurs, such as a hotel is built and sold? Will it continue indefinitely?

The authority and duties of the partners. Very often partners come together to combine unique talents in a partnership. When this occurs the partners' authority and duties are generally divided along their specialties. For example, one partner may be responsible for finance, one for marketing, and a third for operations.

The amount invested by each partner. Partners bring time, money, and property to a partnership. The agreement should clearly put a value on each partner's initial contributions. For example, one partner may contribute a $150,000 warehouse, another $150,000 in cash, and a third partner might contribute $50,000 worth of organizational work for the partnership and an additional $100,000 in cash.

Salaries of the partners. Partners can pay themselves salaries or get no salary and only share in the profits. In order to avoid problems it is best to agree before partners begin work on whether they will get a salary for their efforts, or a share of the profits.

How profits are to be shared. Partners can share profits any way they choose. Many partners share profits based on initial contributions. Two partners each contributing equally would share 50-50. Perhaps one partner does more work or had the original idea and gets 75 percent of the profit compared to 25 percent for the other partner.

Provisions for adding partners and selling partnership interests. As the business and its partners change, the partnership may need more partners and existing partners may want to leave. A good agreement anticipates these situations and makes provisions for partners who are joining or leaving the business. This helps the partnership operate smoothly during times of changing ownership.

How the partnership may be terminated. The partners should consider different options for dissolving the partnership. This will help to avoid a fight over who gets what when the partners decide to dissolve the partnership. It is best to agree on this in the beginning because many times there are hard feelings when it comes time to dissolve the partnership, and at that time it may be difficult to get an agreement.

Following are additional areas usually covered in a good partnership agreement:

- The date of the agreement
- The names and address of all the partners
- The nature of the business
- The specification of each type of partner (whether general or limited)
- Accounting procedures to be used
- Restraints on each partner, if any
- Provisions for altering or modifying the agreement as circumstances warrant

Partnerships, like many pursuits, do not always last. Partners can help make their relationship stronger and smoother by going through the process of developing a written partnership agreement. Usually an attorney helps the partners through the process. A well-drafted partnership agreement can help the partners avoid unnecessary disputes that could ruin their business relationship.

Most people find it helpful to get the advice of an attorney when drafting a partnership agreement. An attorney can help the partners anticipate future problem areas and suggest ways to prevent the problems from hurting the business. An attorney not only has the legal expertise to draft a legally enforceable agreement, but as an uninvolved third party, often has the ability to identify potential problem areas and develop ways to avoid these potential problems up front.

WHAT IS A CORPORATION?

A corporation is a very special form of ownership. Once created, a corporation has rights, privileges and responsibilities similar to a person. In legal terms, the corporation is considered to be a separate legal entity from its owners. As a separate legal entity, the corporation can do almost any act a person can do. It can enter into contracts, sue, be sued, own property, commit crimes, and conduct business in its own name. For example, when the Exxon Valdez spilled oil into the ocean near Alaska, criminal charges were brought against Exxon, the corporation, not its owners.

The owners of a corporation are shareholders who own stock issued by the company. The shareholders elect a board of directors who select a management team to run the company. In a small business setting, the principal owner and his or her family may own all the stock, serve on the board of directors and manage the business.

Corporations are the most complicated way to start and run a business. Each state has laws which require corporations to hold shareholder meetings and board of directors meetings, maintain minutes of the meetings and file various reports with state agencies. These requirements must be met and corporations must pay fees to the state in order to have the right to continue to do business as a corporation.

WHAT ARE THE ADVANTAGES OF A CORPORATION?

Corporations offer several possible advantages. The owners (shareholders) have limited liability for the debts of the business. Typically, a shareholder is only at risk to lose the amount he or she has invested in the business. Personal assets are not at risk. This is a great advantage over having unlimited personal liability as is the case for the sole proprietors and general partners.

Another advantage is that the corporation exists as a separate entity from its owners. This makes the corporation stable because the death or disability of an owner does not automatically terminate the business as it does with other forms of business ownership.

The corporate form also makes it easier to transfer ownership interests. The share-

holders' ownership interests are represented by shares of stock. Ownership interest in a corporation is transferred by selling stock to the new owner. Existing owners can transfer all or part of their stock interest to each other or to outsiders by selling them their stock.

Finally, corporations can raise capital easier than partnerships or sole proprietorships. The advantage is greatest for larger, more established companies that can sell stock on major stock exchanges. Smaller start-up corporations often find that raising capital is very difficult. It is hard to find investors who are willing to buy stock in a small company with little operating history.

main business. See Figure 3 for a summary of the advantages and disadvantages of a corporation.

WHAT ARE THE DISADVANTAGES OF A CORPORATION?

A major disadvantage of the corporate form of ownership is that it is the most regulated type of ownership. Even if a corporation has only one owner, reports must be filled out and federal, state, and local regulations similar to those required of IBM or other large corporations must be complied with.

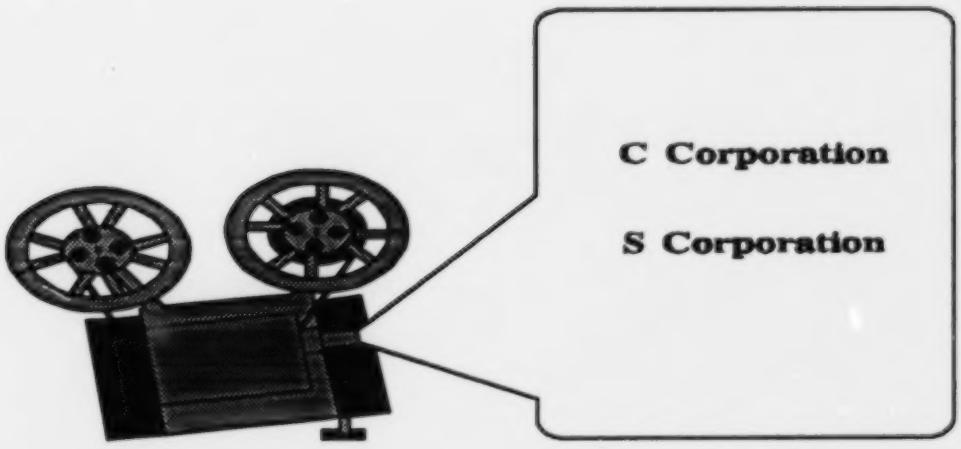
ADVANTAGES	DISADVANTAGES
• Owners' liability limited to amount invested • Easy to transfer ownership • Business entity separate from owners • Greater availability of management expertise • Possible tax advantages	• Expensive to form • Highly regulated • Most complicated paper work required on a daily basis • Double taxation possible

Figure 3. Summary of the Advantages and Disadvantages of a Corporation

A corporations' profits can be double taxed if the owners do not actively manage their tax situations. Because a corporation is a separate entity, it must pay taxes on its income. Corporate profits are first taxed before they are paid out to shareholders. Shareholders must also pay taxes on profits the corporation pays them. This is referred to as *double taxation* of corporate profits. With proper tax planning, however, it can be avoided. Tax planning, like paper work, diverts the owners time and money from the

This requires small business owners to divert time and money from their regular business to handle the paperwork.

The process of incorporating is more complicated and expensive. Usually an attorney is hired to prepare and file the incorporation papers. Special fees are charged by each state to have the right to carry on business in that state. The initial costs of starting a corporation can be significantly higher than those of other types of ownership.



WHAT ABOUT THE CORPORATION AND TAXES?

Presently, there are two categories of incorporation for taxation purposes—*C corporations* and *S corporations*. Any business can choose to be taxed as a *C corp*. Big corporations with millions of stockholders, such as General Motors, are always taxed as C corps. Since 1986, individuals have paid a lower top tax rate than C corps. The appeal increases the lower rate of S corp status.

In 1986 Congress created the *S corporation* tax status to encourage smaller business development by eliminating double taxation of their profits. *S corps* are not treated as separate taxpayers; they are taxed like a partnership. S corp profits flow through the corporation to shareholders who are then taxed at the individual rate. No corporate income tax is paid on the profits. Ultimately, many small business owners adopted S corp status to avoid double taxation of earnings.

A business must meet several requirements to qualify for *S corporation* status. The most significant requirements include the following:

- Firm must have 35 or fewer shareholders.
- Firm must be a domestic corporation.
- Shareholders can not be nonresident aliens.
- Only one class of stock can be outstanding.
- Shareholders must be individuals, trusts, or estates (no corporate shareholders are allowed).

The merits of S corp status came under serious question in the early 1990's with the increase of individual federal income tax. This increase created a circumstance where top individual rates became higher than corporate rates. The benefits of avoiding

double taxation do not come without a price. The laws governing *S corporations* are fairly complicated and, are subject to change from year to year. This is not to say that S corp status may not still be appropriate in some situations. However, it is strongly recommended that anyone considering this option should seek advice from a tax attorney before making a final decision.

HOW IS A CORPORATION FORMED?

The requirements for incorporating are governed by state laws and vary from state to state. All states, however, require a *corporate charter* to be filed with the state in order to incorporate. Some of the information most commonly required in a charter is as follows:

- The specific name of the corporation. The name cannot be the same as one already in use in that state when the charter is issued.
- The purpose of the corporation, which may be as general as any lawful purpose.
- The names and addresses of the directors and incorporators. Depending on the state, one to five incorporators must reside in the state in which the application is made.
- The location of the company's main office.
- The duration of the corporation, which is usually said to be in "perpetuity" since corporations do not normally have a specific ending date.
- The amount and kinds of capital stock authorized at the outset of the operations.
- A full description of the voting rights of the stockholders.

The original owners must also draw up a set of *bylaws*. The bylaws are the internal rules and regulations of the corporation. They protect all the owners, present and future, from unwise or selfish decisions by the board of directors. They then pay a charter fee (which varies from state to state and can be quite expensive) and a certificate of incorporation is issued. All agreements are made in the name of the company and not in the owners' names. At that point, the corporation is authorized to do business in that state. If it will be doing business in other states, it must register as a foreign corporation in each state it wishes to do business and pay the appropriate fees.

Figure 4 represents an example of the Articles of Incorporation. The requirements that need to be met in order to obtain a corporate charter are very technical and vary from state to state. A good business attorney, familiar with the laws in the state where you want to incorporate, should be consulted to determine if, and how, you should incorporate your business.

ARTICLES OF INCORPORATION

We, the undersigned natural persons of the age of 21 years or more, acting as incorporators of a corporation under the Business Corporation Act, adopt the following Articles of Incorporation for such corporation:

FIRST: The name of the corporation is: _____

SECOND: The period of its duration is: _____

THIRD: The purpose or purposes for which the corporation is organized are:

_____

FOURTH: The total number of shares that the corporation shall have authority to issue is:

_____

FIFTH: The corporation will not commence business until at least one thousand dollars has been received by it as consideration for the issuance of the shares.

SIXTH: Provisions limiting or denying to shareholders the preemptive right to acquire additional or treasury shares of the corporation are: _____

SEVENTH: Provisions for the regulation of the internal affairs of the corporation are:

_____

EIGHTH: The address of the initial registered office of the corporation is:

_____

and the name of its initial registered agent at such address is:

_____

NINTH: The number of directors constituting the initial board of directors of the corporation is _____ and the names and address of the persons who are to serve as directors until the first annual meeting of shareholders or until their successors are elected and shall qualify are:

Name Address

_____

_____

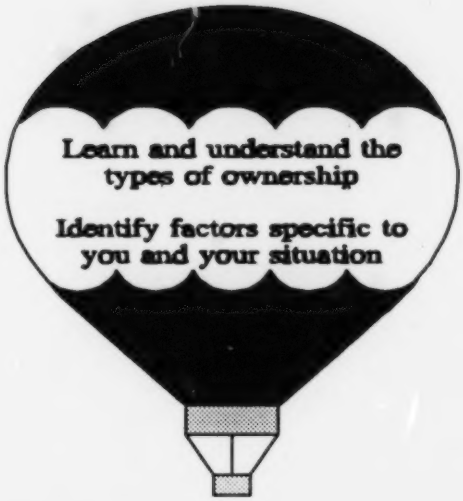
TENTH: The name and address of each incorporator is:

_____

Dated: _____

SOURCE: Hodgets, R. M. *Effective Small Business Management.* New York: Academic Press, 1982, p. 179.

Figure 4. Articles of Incorporation



HOW CAN YOU ANALYZE YOUR BUSINESS SITUATION TO DETERMINE THE TYPE OF OWNERSHIP?

Learning about and understanding the types of ownership is the first step in choosing the type of ownership that best suits your needs. The second step is identifying factors that are specific to you and your situation that will influence your decision. These factors involve your financial situation, your personal characteristics, the riskiness of your business, and your plans for the business.

Your financial situation can be a very important factor in choosing the type of ownership. The more wealth you have, the more protection you need. For instance, a business executive that has worked 40 years and retired as a millionaire most likely would not want to incur personal liability for a new small business that they wanted to start. Therefore, the business would usually avoid forming a sole proprietorship or a partnership in favor of forming a corporation to shield its personal assets. The extra expense and paper work involved in forming and running a corporation would more than be compensated for by the added protection the business would get from a corporation.

At the other extreme is the person who is just starting out in the business world and has accumulated very little wealth. They must use everything to start the business. The bank may even require the owner to be personally liable for all business loans regardless of what type of ownership they should choose. In this type of situation, where an entrepreneur invests all they own in the business, a sole proprietorship or partnership may be more appropriate. These types of ownership cost less and are easier to form and run than a corporation. This, coupled with the fact that the corporation's chief advantage of *no personal liability* means very little in this situation, may well tilt the scales in favor of forming a sole proprietorship or partnership.

Another aspect of your financial situation that comes into play is the tax status. The greater your tax liability is, the more you have to examine how the various types of ownership can be used to lessen your tax burden. Which one would lower your tax bill the most varies from situation to situation. This can also vary year to year as Congress changes the tax laws. Reviewing your tax situation with a tax attorney or accountant before you start your business will help you to structure your business in such a way to pay the least amount of taxes.

Your personal characteristics play an important role in helping you choose a type of ownership. Do you dislike taking risks? Corporations are generally viewed as less risky than the other types of ownership. The tradeoff for less risk is more *regulation.* Dealing with corporate regulation requires a detail-oriented personality and self-discipline. Records have to be maintained and forms filed on time. The corporate accounts have to be kept separate from personal accounts.

An important personal factor is whether you want to have co-owners or not. Some people prefer to make all the decisions themselves whereas others prefer to tackle problems as a team. As discussed earlier, deciding whether you will have co-owners helps you eliminate one of the three options. Single-owned businesses can eliminate partnerships and multi-owner businesses can eliminate sole proprietorships. Narrowing your options helps you focus your analysis early on in the process.

The riskiness of your business can influence your choice. Using the corporate form of ownership is one way to protect yourself from personal liability for business matters. The riskier your business venture, the more likely you are to want to choose the corporate form of ownership. Combining the proper use of insurance with the protection of a corporation can shield your personal assets from creditors in the event your business fails.

Your plans for business will influence your decision. If you have a great idea that requires a large amount of capital you may have to form a partnership or a corporation to raise the needed capital. It is generally easier to raise capital with these types of ownership than with a sole proprietorship. Additionally, if you plan on taking on new co-owners or selling part of the business, you may want to form a corporation to facilitate transferring ownership. Ownership interests in corporations are easiest to transfer.

Analyzing the type of ownership requires a thorough knowledge of all types of ownership and your particular set of circumstances. Then you must carefully weigh the advantages and disadvantages to see which type of ownership will best meet the needs presented by your particular situation. As your situation changes from time to time, you should go through and reanalyze your choice to determine if a different form of ownership would better suit your new needs.

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HOW CAN OUTSIDE ASSISTANCE HELP YOU MAKE A BETTER CHOICE OF OWNERSHIP?

Most people find outside assistance is very useful in helping to choose a form of ownership. Sources of assistance include attorneys, accountants, mentors, the Small Business Administration, etc.

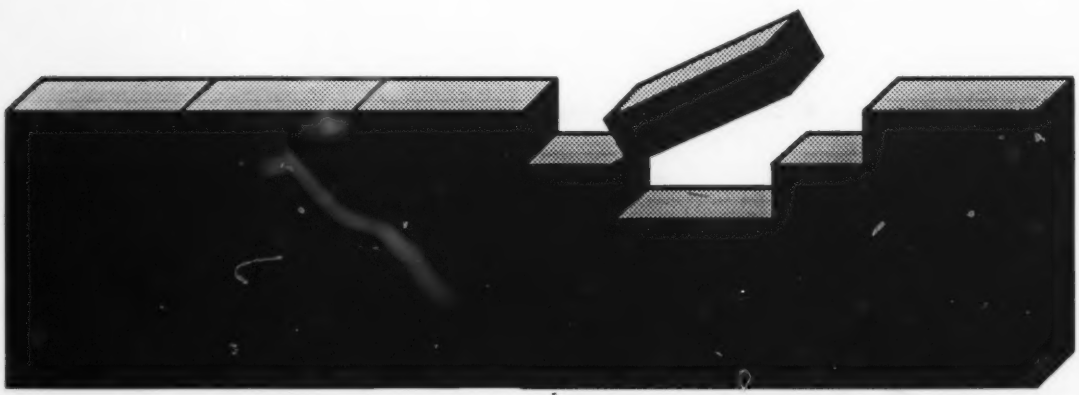
Choosing a type of ownership involves many technical issues. Your attorney and accountant can help you understand the complex tax and business laws and how they impact your choice. These professionals keep current on changing laws that affect your choice. They also have a wide variety of experience dealing with all types of situations. This experience helps them give you a better perspective on your situation and options.

In addition to having technical expertise and experience, professionals giving outside assistance often are able to view your situation more objectively than you are. It is easier for them to give objective advice since it is not their money, effort and livelihood on the line in the new venture.

Starting a business requires a positive attitude and desire to overcome all the odds. Although these attitudes are good for getting the business started, they often cause entrepreneurs problems. Entrepreneurs sometimes ignore potential problems in order to focus on the positive. A neutral third party can often see the potential problems and devise ways to protect against them, without causing the entrepreneur to lose his or her positive focus.

A good example of this is when two partners first start their business. Their focus is on launching the business not on how to dissolve it. However, we know that most businesses end sooner or later. A good advisor will help the partners come up with a written plan to deal with dissolving the partnership in the event that it becomes necessary. The partners might ignore the potential problem until one of them wants to quit or dies. At that time, it might be much harder to come up with an acceptable plan for terminating the partnership.

Getting outside assistance can help you make the best choice of a type of ownership. Potential problems can be identified and preventative measures can be taken early. Remember, your choice of ownership will provide the building blocks for your business—choose carefully.



ACTIVITIES

The following activities are designed to help you apply what you have learned in this unit.

INDIVIDUAL ACTIVITIES

A.

Analyze the situation to determine which type of ownership you would choose. Make two charts, one listing personal characteristics that influence your decision and the other listing characteristics of the business you plan to start. Make the charts so that they start with the item that is most important to your decision and go down in order of importance. Next to each factor list the type of ownership that would best deal with that item. After you have completed the charts, use them to analyze what type of ownership would be best for you and your business. What form of ownership would you choose? Why?

B.

Find a person in your community who you think would be a good mentor for you. This could be a successful business person or anyone you respect that has a strong business background. Ask them to help you analyze the pros and cons of starting your business as a sole proprietorship, a partnership, and a corporation. Be prepared to explain your business and your situation to them when you ask them. The better information you give them, the better advice they will be able to give you.

GROUP ACTIVITIES

A.

Work in teams of five to six. Each team collects as much information as possible on the steps necessary to form a corporation in your state. Good sources of information are the local small business administration office, the local library, the law school library, the Secretary of States' office, and local business attorneys. Teams should request copies of the forms needed to form a corporation. When the information has been compiled, each team fills out the forms. The instructor provides assistance as needed.

B.

Work in teams of four to six. Each team divides into two teams, team I and team II, for the purpose of debating. Team I supports the position that most small businesses should be formed as sole proprietorships. Team II supports the position that most small businesses should be formed as corporations. Each team prepares for the debates by reviewing the advantages and disadvantages of sole proprietorships and corporations. During the debate use flip charts to record the ideas presented. After the debate, teams compare ideas and makes a comprehensive list of the ideas presented.

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CASE STUDY

Rollie is a junior in college. He attends class part time in the evenings as a marketing major. He has an idea and would like to start his own small business.

The business he wants to start is a windshield wiper and auto fluid stand. This involves renting an old Fotomat booth in the parking lot of the local shopping center and selling windshield wiper blades and auto fluids from it. He thinks the need for this service was created when gas stations stopped doing these services for motorists.

The business involves very little risk. The services provided are safe and easy to perform and the inventory costs are not very high.

Only one other employee will be needed to cover the time when Rollie is unable to tend to the business.

Rollie will invest his lifesavings of $5,000 in the business. This will pay for inventory, a sign, a cash register and the first few months rent. The remainder of the $5,000 will serve as working capital. Virtually all that he has will be invested in the business. By continuing to work part time on the third shift at a local factory, he will be able to stay in school and pay his personal expenses until his new business starts to cash flow. If all goes well, in 3 to 5 years he hopes to open one or two more stores. However he does not want to go into debt to grow. He would like to remain as free as possible to run his business in any way he chooses.

DISCUSSION QUESTIONS

1. What advice on choosing a type of ownership would you give Rollie if he asked you to be his mentor?

2. Would you recommend that he look for co-owners? Why or why not?

3. Which type of business ownership would you recommend that he choose? Why?

4. Which factors influences your recommendation?

ASSESSMENT

Read the following questions to check your knowledge of the topics presented in this unit. When you feel prepared, ask your instructor to assess your competency on them.

1. List the steps necessary to create a sole proprietorship, a partnership, and a corporation.

2. Identify at least five factors which influence your choice of ownership and explain how they affect your choice.

3. Explain how a partnership agreement can be used to help build a successful multi-owner business.

4. Identify at least four reasons to seek outside assistance when making your ownership choice.

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PACE

Unit 1. Your Potential as An Entrepreneur
Unit 2. The Nature of the Small Business
Unit 3. Business Opportunities
Unit 4. Global Markets
Unit 5. The Business Plan
Unit 6. Help for the Entrepreneur
⇨ Unit 7. Types of Ownership
Unit 8. Marketing Analysis
Unit 9. Location
Unit 10. Pricing Strategy
Unit 11. Financing the Business
Unit 12. Legal Issues
Unit 13. Business Management
Unit 14. Human Resources
Unit 15. Promotion
Unit 16. Selling
Unit 17. Record Keeping
Unit 18. Financial Analysis
Unit 19. Customer Credit
Unit 20. Risk Management
Unit 21. Operations
Resource Guide
Instructor's Guide

Units on the above entrepreneurship topics are available at the following levels:

* Level 1 helps you understand the creation and operation of a business
* Level 2 prepares you to plan for a business in your future
* Level 3 guides you in starting and managing your own business